September 19, 2005

Members of the Investment Committee
California Public Employees' Retirement System
Lincoln Plaza, 400 P Street, Suite 3492
Sacramento, CA 95814

Re: Equity Real Estate Leverage Policy Amendments Regarding Recourse Debt

Dear Members of the Investment Committee:

Pension Consulting Alliance, Inc. ("PCA") has reviewed the staff's recommendation to modify the current Equity Real Estate Leverage Policy. We have discussed with staff our perception that there is an ambiguity in the policy with regards to the use of recourse guarantees.

At the outset we should indicate that PCA believes that from time the use of CalPERS overall credit can be used to add significant value to the portfolio by guaranteeing certain obligations. However, we believe, and staff concurs, that the use of CaLPERS overall credit should be used judiciously, and be subject to overall policies, procedures and constraints.

These general guarantees would come into play to augment returns primarily in the context of lines of credit used in lieu of conventional real estate financing, i.e., first mortgage debt or construction financing, or in the form of credit enhancements.

In these circumstances CalPERS' overall credit is used to obtain more favorable financing terms than would otherwise be available to the partner. However, unlike traditional real estate financing (non-recourse) in which CalPERS liability would be limited to the equity commitment of the particular investment, the exposure to CalPERS in these recourse guarantees is potentially greater than the equity commitment to the particular investment. For example, in development projects it is common industry practice for the leverage ratio to be quite high. The amount of the potential liability depends on the dollar amount that is guaranteed. However, the ratio of equity to debt could range from two to four times, with the potential exposure being the equity invested plus the amount of the debt guaranteed.

This practice has limited historical use, at least based upon our understanding of the terms of the financing used by the real estate staff. To date, PCA has not been involved in the negotiation of the underlying debt incurred in the real estate portfolio.

The issue surfaced when PCA was asked to review the potential use of these general recourse obligations in connection with one of the opportunistic investment partners in emerging markets. In these emerging markets conventional construction and permanent financing (at least when compared to U.S. alternatives) is often not available. In reviewing the policy, a few issues became apparent.

First, PCA interprets the present language to allow the Staff use of general CalPERS' guarantees, but there is no limit whatsoever on their use. Theoretically, as we read the language, the staff could use the guarantees to pledge a significant percentage of CalPERS composite investment portfolio. While we view the risk of this to be remote, we still believe the better practice is to constrain the use of these general guarantees to a prudent amount of the total investment portfolio. PCA has proposed and Staff concurs that a 2% cap of the total investment portfolio on the use of these general CalPERS guarantees class is a prudent limit for the real estate asset class.

Second, when general CalPERS guarantees are used, PCA believes the partner should be required to compensate CalPERS for the use of its credit in some amount (i.e., a credit enhancement fee) or the overall relationship with the partner should take the value of the guaranty into account. In effect, the partner leverages off CalPERS' credit to augment the returns by obtaining far more favorable financing rates than they otherwise could obtain in the general market. The augmentation of the return boosts their profit participation without necessarily a corresponding alpha contribution being generated by the partner. There is an amount to be negotiated between CalPERS and the partner for the use of CalPERS credit. Staff is aware of this issue and is taking it into account in their conversations with CalPERS' partners who want to utilize these general guarantees.

Third, PCA recommends that the Real Estate Unit track and incorporate into the Investment Committee reports on the overall real estate portfolio, for example, when the annual business plans are presented, a summary of the amounts outstanding pursuant to these general guarantees. In that way, the Investment Committee can monitor the outstanding amounts being pledged under the guarantees. Staff has indicated to PCA that going forward these amounts will be tracked and disclosed to the Investment Committee.

Fourth, PCA believes the use of CalPERS credit in the real estate portfolio is not simply a real estate asset class issue. The use of these off-balance sheet guarantees should be tracked and monitored at the composite portfolio level as these guarantees are being used in other asset classes. For example, in fixed income, a credit enhancement program exists in which CalPERS general credit is also used. We suggest a few considerations about these practices.

PCA recommends the Investment Committee consider adopting an overall investment portfolio limit to the use of these off-balance sheet guarantees, inclusive of the recommended 2% portfolio limit recommended for the real estate asset class. Contingent liabilities are just that, but they do incur some level of risk that may not necessarily be reflected on the balance sheet of the composite portfolio. There is some prudent limit that we recommend be considered for the entire portfolio. This issue is for the CIO and the Investment Committee to discuss along with the System's general consultants.

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In sum, PCA believes CalPERS credit rating is itself an asset than should be monitored and apportioned on a judicious basis to those investment alternatives offering the best risk and return premiums. Each of the opportunities to use a CalPERS pledge should be evaluated against competing alternatives for the highest possible risk adjusted return. These may or may not occur only in real estate.

We look forward to discussing these issues with the Investment Committee at the next meeting in September.

Very truly yours,

Nori Gerardo Lietz

Nori Gerardo Lietz
Managing Director

cc: Mark Anson
Michael McCook
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